

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE:) CHAPTER 7
)
KIRK DONOVAN) CASE NO. 01-69431-MHM
)
Debtor)

)
PAUL H. ANDERSON, JR., Trustee)
) **ADVERSARY PROCEEDING**
Plaintiff) **NO. 03-9357**
)

v.)

)
HSN, LP, INGENIOUS DESIGNS, INC.,)
INGENIOUS DESIGNS, LLC,)
JOY MANGANO)
)
Defendants)

ORDER DENYING DEFENDANTS' MOTION TO DISMISS

This matter is before the court on the motion of Defendants HSN, LP (“HSN”),¹ Ingenious Designs, Inc. (“IDI”), Ingenious Designs, LLC (“IDI, LLC”) and Joy Mangano (“Mangano”) (collectively, “Defendants”) to dismiss this adversary proceeding in its entirety with prejudice. This adversary proceeding was filed by the Chapter 7 Trustee on behalf of The Donovan Group, Inc. (“DGI”), a corporation wholly owned by Debtor, to prosecute DGI’s state law claims against Defendants.

In the motion to dismiss, Defendants argue that the claims alleged by DGI are not within the bankruptcy court’s subject matter jurisdiction because they are neither core proceedings nor

¹ Plaintiff alleges that in 2000 HSN acquired 100% ownership of IDI.

claims related to a bankruptcy proceeding. Additionally, Defendants seek dismissal of DGI's complaint under F.R.C.P. 12(b)(2) for lack of personal jurisdiction over the Defendants. DGI contends that the bankruptcy court may exercise subject matter jurisdiction over this adversary proceeding because the proceeding is "related to a case under Title 11" within the meaning of 28 U.S.C. § 157 and, consequently, that the exercise of personal jurisdiction over the Defendants by the bankruptcy court is proper. For the reasons set forth below, Defendants' motion to dismiss is denied.

Statement of Facts

Debtor, the sole shareholder in DGI, filed a Chapter 7 petition July 24, 2001. As a result, Debtor's Trustee holds all stock in DGI as property of the estate under 11 U.S.C. § 541(a). DGI is a Subchapter S Corporation organized under the laws of Georgia. Trustee commenced this adversary proceeding to prosecute DGI's claims against Defendants for breach of contract, fraud, alter ego liability, and fraudulent transfer(s).

In response to Trustee's complaint, Defendants filed a motion requesting abstention under 28 U.S.C. § 1334(c)(1). In that motion, Defendants argued that Trustee lacked standing to bring these claims on behalf of DGI because the claims were direct rather than derivative. In response, Trustee caused DGI to file a motion to intervene under Bankruptcy Rule 7024, which incorporates F.R.C.P. 24. Although DGI's motion to intervene was procedurally deficient, the motion was construed as a motion to join DGI as a party at interest under Bankruptcy Rule 7019, which incorporates F.R.C.P. 19. An order was entered joining DGI as a plaintiff and dismissing Trustee for lack of standing. DGI's claims were characterized as direct claims and the adversary

proceeding was characterized as a non-core proceeding. Defendants' request for abstention was denied.²

Defendants argue that this adversary proceeding should be dismissed because the bankruptcy court lacks subject matter jurisdiction. Defendants correctly point out that no party in this case is a party in Debtor's Chapter 7 bankruptcy proceeding. Because this adversary proceeding is not a core proceeding, Defendants argue, a bankruptcy court cannot have subject matter jurisdiction over it unless the proceeding is "related to" a bankruptcy case within the meaning of 28 U.S.C. § 157. Defendants claim that the "related to" test is not met because any amount that DGI may recover from Defendants would become the property of DGI, which is not a debtor and, therefore, the outcome of this adversary proceeding can have no impact on Debtor's Chapter 7 case. If the "related to" test of 28 U.S.C. § 157 is not met, both subject matter jurisdiction over the proceeding and personal jurisdiction over the Defendants are absent. Plaintiff answers that, although DGI is not a debtor, DGI's stock remains property of Debtor's bankruptcy estate. Because any recovery by DGI will inevitably benefit the holder of DGI's stock and therefore inure to the benefit of Debtor's bankruptcy estate, the outcome of this adversary proceeding will have a significant impact on Debtor's case sufficient to pass the "related to" test.

Discussion and Conclusions of Law

² See order entered September 27, 2004.

The two issues raised in Defendants' motion to dismiss are the propriety of subject matter jurisdiction over this proceeding and personal jurisdiction over Defendants. Because the former is dispositive of the latter, the discussion begins with subject matter jurisdiction.

Subject Matter Jurisdiction

Subject matter jurisdiction for bankruptcy courts is described in 28 U.S.C. § 157, which provides jurisdiction over cases arising under title 11, core proceedings, and cases "related to" a case under title 11. Debtor's Chapter 7 bankruptcy petition is a case arising under title 11. This adversary proceeding is not a core proceeding.³ However, 28 U.S.C. § 157(c)(1) provides that "[a] bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11." Defendants argue that this proceeding does not fall within the "related to" jurisdiction of the court.

The determination of whether a case falls within a bankruptcy court's "related to" jurisdiction was enunciated by the U.S. court of Appeals for the Third Circuit as follows:

The usual articulation of the test for determining whether a civil proceeding is related to bankruptcy is whether *the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy*. Thus, the proceeding need not necessarily be against the debtor or against the debtor's property. An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate.

Pacor, Inc. v. Higgins, 743 F. 2d 984, 994 (3d Cir. 1984) (emphasis in original). This test, often referred to as the "Pacor" test, was approved by the U.S. Supreme Court in *Celotex Corp. v.*

³ See order entered September 27, 2004.

Edwards, 514 US 300 (1995), and adopted verbatim by the 11th circuit, *Miller v. Kemira, Inc.* (In re *Lemco Gypsum, Inc.*), 910 F. 2d 784 (11th Cir. 1990).

Defendants argue that this proceeding fails to meet the *Pacor* test for “related to” jurisdiction on two grounds. Defendants argue first that, because the claims asserted by Plaintiff in this proceeding are direct claims by DGI, a non-debtor, any recovery to which DGI may be entitled will become property of DGI and not the Chapter 7 Debtor. Because Debtor cannot recover directly on DGI’s claim, Defendants argue, this proceeding cannot affect Debtor’s rights, liabilities, options, or freedom of action. Defendants’ second argument merely restates the first and concludes that, because Debtor cannot recover directly on DGI’s claim, this proceeding cannot have any impact on the administration of Debtor’s estate.

Defendants’ characterization of the *Pacor* test, however, is overly narrow and inconsistent with prior rulings of the Eleventh Circuit Court of Appeals. In *Pacor*, the court stated that “Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expediently with all matters connected with the bankruptcy estate.” 743 F. 2d at 994. The *Pacor* test does not require that an adversary proceeding have a direct, substantial, or even definite effect on a proceeding under Title 11. *Pacor* requires only that this proceeding have a *conceivable* effect on Debtor’s Chapter 7 case. In adopting the “Pacor” test, the Eleventh Circuit Court of Appeals noted that some circuits had adopted a more restrictive form of the test. *Miller*, 910 F. 2d at 788 n.19. These restrictive tests “may deny jurisdiction in cases where the dispute’s probable effect on the debtor’s estate, while conceivable,

is nonetheless remote.” *Id.* In contrast to those circuits which adopted a restrictive *Pacor* test⁴, the Eleventh Circuit Court of Appeals chose to join the majority of circuits by not restricting the *Pacor* test and adopting the language from *Pacor* verbatim.

This adversary proceeding passes the *Pacor* test because its outcome will conceivably have an effect on Debtor’s bankruptcy estate. Although Defendants correctly state that any recovery obtained by Plaintiff will accrue directly to DGI and not to Debtor’s estate⁵, the claim asserted by Plaintiff need not be a claim of Debtor nor a claim that will result in a direct recovery by Debtor’s estate to pass the *Pacor* test. Trustee holds all of DGI’s stock as property of the estate. 11 U.S.C. § 541(a). A recovery against Defendants by DGI would increase the value of DGI’s stock. In addition to increasing the value of DGI’s stock, a recovery in favor of Plaintiff would provide DGI with liquid assets, and Trustee could conceivably use his position of control over DGI as sole owner of DGI’s stock to declare a dividend of these assets in favor of Debtor’s estate. An increase in the value of DGI’s stock or the declaration of a dividend in favor of Debtor’s estate would conceivably alter Debtor’s rights, liabilities, options, or freedom of action and impact the administration of the bankruptcy estate; therefore, the bankruptcy court’s assertion of subject matter jurisdiction over DGI’s claims is proper.

⁴ The Second, Sixth and Seventh Circuit Courts of Appeal have adopted a restrictive form of the *Pacor* test..

⁵ In his response to Defendants’ motion to dismiss, Plaintiff appears to be confused about the effect of DGI’s status as a subchapter S corporation. A subchapter S corporation is a “pass through” entity in the limited sense that the shareholders in a subchapter S corporation report the profits or losses of the corporation on their individual tax returns. Profits do not actually pass through a subchapter S corporation into the possession of its shareholders absent the declaration of a dividend by the corporation. To qualify for subchapter S status, a corporation must have 75 or fewer members and no more than one class of stock.

In arguing that an increase in the value of DGI's stock will neither alter the debtor's rights, liabilities, options, or freedom of action nor impact the administration of the bankruptcy estate, Defendants rely primarily on *Equity Broad. Corp. v. Shubert* (in re *Winstar Communications, Inc.*), 284 BR 40, 51 (Bankr. D. Del. 2002).

In *Shubert*, the Delaware court was presented with a situation somewhat similar to that presented here. The question presented was whether, under the "Pacor" test, a bankruptcy court has jurisdiction to hear an adversary proceeding between two non-debtors when the bankruptcy trustee is the sole shareholder of the parent corporation of the non-debtor subsidiary asserting a claim against another non-debtor. In holding that a bankruptcy estate does not have such jurisdiction, the Delaware court stated that although the action "may have an effect on the ultimate value which the estate receives from the stock it owns, it does not alter the estate's rights, liabilities, options or freedom of contract." 284 BR at 51. The reasoning proffered by the Delaware court in so holding was that "[i]f the court were to find that this action was under the jurisdiction of the Bankruptcy Court, the decision would have the result of bringing every wholly owned subsidiary into every Bankruptcy case regardless of the circumstances and without the safeguards afforded by schedules, statements of financial affairs, notices to creditors, or meetings of creditors." *Id.*

The decision in *Shubert*, however, is not controlling over the issues presented here. In *Shubert*, the bankruptcy estate was not the sole shareholder of the non-debtor asserting the claim at issue. Rather, the bankruptcy estate was the sole shareholder of the non-debtor's parent corporation, which in turn was the sole shareholder of the non-debtor asserting the claim. Therefore, the effect that a successful prosecution of the non-debtor's claim would have on the bankruptcy was more remote than obtains here. In the instant case, the bankruptcy estate is the

sole shareholder of DGI, the entity asserting the claim against Defendants. Trustee has complete control over DGI, has access to all its books and records, and stands in the shoes of the sole shareholder.

The language of the *Pacor* test is clear and inclusive. A bankruptcy court has “related to” jurisdiction over an adversary proceeding between two non-debtors when the outcome of that proceeding could “conceivably have an effect on the estate being administered in bankruptcy.” A recovery in favor of DGI would bring liquid assets into DGI that could conceivably effect the administration of Debtor’s bankruptcy estate on two grounds: it could increase the value of DGI’s stock, or it could result in the declaration of a dividend in favor of the estate. Either result would increase the value of the assets in debtor’s estate, which would, in turn, affect the estate’s administration. Therefore, subject matter jurisdiction over DGI’s claim against Defendants is proper.

Personal Jurisdiction Over the Defendants

Defendants’ sole basis for objecting to the bankruptcy court’s assertion of personal jurisdiction is that when subject matter jurisdiction is improper, service of process on the Defendants cannot render personal jurisdiction proper. Having concluded that subject matter jurisdiction *is* proper, the personal jurisdiction argument is without merit. Therefore, personal jurisdiction is proper. Accordingly, it is hereby

ORDERED that Defendants’ motion to dismiss the complaint is denied.

The Clerk, U.S. Bankruptcy Court, is directed to serve a copy of this order upon Plaintiff's attorney, Defendant's attorney, and the Chapter 7 Trustee.

IT IS SO ORDERED, this the ____ day of March, 2005.

MARGARET H. MURPHY
UNITED STATES BANKRUPTCY JUDGE